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The Role of Commercial Banks in Enterprise Restructuring in Central and Eastern Europe

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In Central and Eastern Europe, banks are less active than planned in enterprise restructuring. Corporate restructuring is not normally a major part of commercial banking — to ask banks to restructure their weakest clients is to direct attention away from lending to their strongest clients, which should be their core business. Enterprises are thus being restructured not by banks or government agencies but by brutal market forces.

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Summary findings

Many countries in Central and Eastern Europe assigned banks the responsibility for restructuring enterprises. Such restructuring had five components:

- Triage of enterprises into three classes: viable, viable with debt relief, and nonviable.
- Work with management of overindebted firms on a restructuring plan before granting debt relief.
- Trigger the bankruptcy-liquidation process on nonviable firms.
- Fund new investments needed as part of physical restructuring.
- Provide corporate governance through representation on boards of directors.

The initial information is that banks are performing these roles only to a limited degree. Signals are mixed on how vigorously governments want banks to pursue bankruptcy proceedings. With little opportunity to recover funds, banks are accepting even dubious restructuring programs from enterprises. But banks, except under government directive, are avoiding making new loans to loss-making enterprises. Together with a cut in fiscal subsidies, this is imposing a harder budget constraint on the enterprises. Nonviable enterprises seem more likely to starve to death than to die through execution.

Corporate restructuring is not a normal part of commercial banking. To ask banks to restructure weak enterprises is to direct their attention away from what should be their core business: lending to strong enterprises. In fact, banks are under attack for being excessively conservative.

Enterprise restructuring is taking place in Central and Eastern Europe driven by the disintegration of regional trade relations, sharply higher input prices, falling domestic demand, inflation, and other economic dislocations in combination with the harder budget constraint. Thus far the restructuring has been more downsizing than making new investments.

This paper — a product of the Financial Sector Policy and Institutions Unit, Financial Sector Development Department — is part of a larger effort in the department to study the role of banks in restructuring. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Rosamund Garner, room G8-127, extension 37670 (18 pages). February 1995.

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Summary and Conclusion

There is much talk today in Central and Eastern Europe (CEE) and the former Soviet Union (FSU) about bank-led enterprise restructuring. Bank led restructuring consists of five parts: first, banks using their authority as creditors are meant to sort enterprises into three classes, namely fully viable firms, firms that could be viable with debt relief and non-viable firm1/ (or parts of firms). Second, for firms which could be made viable with debt reduction, banks are supposed to work with management to produce a restructuring plan and on the basis of that plan grant the necessary debt relief. Third, banks are expected to take legal action on the non-performing loans of non-viable firms, triggering the liquidation-bankruptcy process. Fourth, for the fully viable firms and those viable after debt relief, banks are expected to provide loans to finance new investments needed as part of the physical restructuring. Fifth, banks are expected to sit on boards of directors to assist enterprises in corporate governance.

The initial information - which is fragmentary at best - is that the banks are performing these roles only to a limited degree. Starting with the last items, active involvement of banks in corporate governance in CEE/FSU and bank financing of investment seem to be the exception, not the rule. But even for the earlier stages of restructuring, banks are less active in their implementation than planned. The signals to banks on how vigorously to enforce foreclosure on non-viable enterprises are certainly mixed. Hence, when banks see little possibility to recover funds through foreclosure proceedings, they appear to be accepting enterprise restructuring programs, regardless of their views on the firms' long-run viability. What the better banks do seem to be doing, and this is important, is to refrain from providing new credits to loss-making enterprises, except under government directive.

1/ The third class can be further subdivided into firms that are value-subtracting with revenues not adequate to cover the cost of purchased inputs and another class of somewhat better firms that can cover the costs of non-labor inputs plus some, though not all, wages.

Because the size of fiscal subsidies to enterprises has been cut, non-viable firms are likely to starve to death, rather than die through a sharp execution.

That the banks are playing a less active role than planned in enterprise restructuring is not surprising. In most countries the main business of banks consists of providing financial services, including payment and deposit facilities and short-term commercial lending. Though commercial banks in developed countries might occasionally be involved in restructuring a troubled client, corporate restructuring is not a major part of the commercial banking business. In CEE/FSU banks are still weak both in terms of finance and skills. To ask the banks to restructure enterprise is to direct their attention away from what should be their core business, that is lending to their strongest clients rather than restructuring the weakest. It is not surprising that banks appear to be less active in restructuring firms than called for in government programs.

Restructuring of enterprises is taking place in CEE/FSU, but it is not bank led. Nor is it being driven by government agencies. Industrial output is down by 40% and industrial employment is down by one-third. But that adjustment has been driven by market forces - the disintegration of regional and CMEA trade relations, sharply higher (non-subsidized) input prices, opening to international competition and falling domestic demand, inflation and other economic dislocations - and reductions in direct subsidies. Thus far the adjustment has been defensive, responding to deteriorating economic conditions rather than active restructuring with new investments to reorganize production lines. Because the countries were overindustrialized at the start of reform, most of the unemployed will be reemployed, not in industry but in the service sectors as the economies recover.

A strategy to stabilize the macro economy and strengthen institutions and markets must be the centerpiece of financial and enterprise reform. Stabilizing the economy, lowering risk, and developing self-correcting mechanisms will largely depend upon improving fundamentals: better information on all aspects of the system, building financial and risk management skills, putting in place laws, regulations and oversight institutions to monitor and safeguard the financial system, clarifying property rights, making financial contracts enforceable, etc. New lending programs or institutions may complement but cannot substitute for the fundamental infrastructure needed for a market based financial system. Putting in place the critical infrastructure should receive top priority.

Introduction

At the onset of transformation, the economies of Central and Eastern Europe and the former Soviet Union were highly distorted and over-industrialized. The incentive structures were perverse and not capable of transmitting information on resource scarcity; individual enterprises were using resources inefficiently; and many industrial products were not competitive in world markets. A massive restructuring of industry was needed as part of restructuring the economy. This included down-sizing the industrial sector to free resources for the service sector, down-sizing or liquidating inefficient enterprises, finding new markets, and introducing new products and more efficient production methods, etc.

No single paper can hope to capture the breadth of experience in the past four years in CEE and the FSU with bank and enterprise restructuring. At the country level the approaches, implementation capacity, and the degree of progress have differed. Rather this paper outlines some of the common policy issues and problems arising in these countries, focussing specifically on the role of banks in the financial restructuring of enterprises. In the discussion on transformation the term "restructuring" has been used to refer to physical changes in production processes, organizational changes including corporatization and privatization, and to financial changes in corporate balance sheets. In order to reduce the confusion somewhat, we shall distinguish among the different aspects of restructuring. Of course, the various aspects are related and financial restructuring can force physical changes.

The Macroeconomic Impetus for Restructuring of Enterprises

The first stage of the adjustment process in CEE/FSU has been driven by traumatic economic collapse. The disintegration of regional and CMEA trade relations, sharply higher energy prices, high inflation, and severe economic dislocation reduced demand forcing the downsizing of the industrial sectors. Between 1989 and 1993 GDP in real terms fell by 30% in CEE and 40% in FSU. Industrial production in most countries declined by 40% and industrial employment by at least one third (see Annex Tables 1 and 2 and Figure 1).

Most of the decline in industrial employment is permanent. The socialist countries were over-industrialized with very small service sectors. Services accounted for only 30-40% of GDP as against over 60% in typical market economies (see Annex Table 3).2/ A decline in industrial employment was certain as the economies shifted resources to the service sectors. That it came so rapidly has led to high unemployment. As the transforming economies recover from the present depression, most of those laid off will be reemployed, not in industry, but in the service sectors.3/

2/ For example, in 1988 Polish industry accounted for 61% of GDP, whereas in OECD the average at the time was 33 % (see *The Economist. Book of Vital World Statistics*. New York, 1990). Moreover, the industrial sector was excessively concentrated and reliant on very large firms. In 1990 nearly half of the Polish workforce was employed in enterprises with between 500 and 2500 workers and most of the remainder worked in enterprises employing over 2500.

3/ In Poland and Hungary over 50% of the workforce is now in the private sector and newly established private firms tend to be concentrated in the trade and service sectors.

At the onset of reform it was stated that many firms could become insolvent because of their high level of indebtedness. Because use of debt as a means of finance had been rather arbitrary under the socialist system, the level of indebtedness did not reflect long run enterprise viability. One suggestion was to write off a large part of the existing debts, particularly at the time of privatization. Without going into the pros and cons of this approach, in practice the original debts were written down substantially in most countries, not by explicit debt forgiveness but by inflation which eroded the real value of debts (see Figure 1). Enterprises, which today are highly indebted, have borrowed heavily since the reform process began, usually to cover losses. Hence the distribution of debt today is more reflective of enterprise performance.

Inflation, which has been high in CEE and very high in FSU, is a two-edged sword in enterprise finance. On the one hand it does reduce the value of enterprise debt, particularly where the rate of interest is less than inflation. But it also reduces the real value of deposits. To avoid the tax imposed by inflation, those who held financial assets shifted to dollars, to foreign deposits, etc. As a result the real value of assets in the banking system declined, reducing the ability of the banking system to provide enterprises with resources (see Annex Table 4). Inflation has been a major force in the financial restructuring of enterprises.

To ameliorate the growing unemployment many governments provided support to the affected enterprises. But after a brief initial tax surplus in the early stage of reform, tax revenues collapsed, reducing the capacity of governments to provide relief. Large fiscal deficits which fed inflation forced governments to cut enterprise subsidies. Furthermore, inflation cut the real value of bank lending so that subsidies through the banking system also were eroded. The cut in both fiscal and financial subsidies put further pressure on the enterprises to adjust to the decline in demand.

Loss-making enterprises reacted to the imposition of a harder budget constraint by creating their own subsidies, that is by not paying banks, other enterprises, the tax authorities, and the social security system. The estimates of bad debts in bank portfolios in CEE countries are in the range of 20 - 40% of total loans, with considerable variation by country and bank. Slowly these arrears loopholes are being tightened as well, as the countries simply can not afford to finance large enterprise losses. As the fiscal authorities have to cover the cost of bank recapitalization, most governments have acted to stem further losses by directing banks to stop lending to insolvent enterprises.

Industrial adjustment has been driven by brutal market forces, not bank or government programs. Devastating economic shocks coupled with declining fiscal subsidies and the real value of bank credits have forced adjustment at the enterprise level. The adjustments thus far have been defensive, responding to deteriorating economic conditions rather than active physical restructuring with new investment to reorganize production. That remains for the future.

Approaches to Restructuring - Bank Restucturing

Each transitional economy has taken a somewhat different approach to restructuring banks and enterprises and coordinating the linkages between the two efforts. Most CEE countries decided to follow a bottom-up approach to industrial restructuring and a top-down approach to banking reform.4/ The government would control the reorganization of banks, while market forces were to play a larger role in forcing restructuring of enterprises. Banks were to be restructured either prior to, or contemporaneously with, the restructuring of the enterprises. The direct restructuring of banks and indirect restructuring of enterprises were to be undertaken in conjunction with four major policy changes: namely, macro-economic stabilization to create appropriate conditions for restructuring, liberalization of relative prices to provide appropriate signals for decision making, privatization of enterprises to generate appropriate incentives, and introduction of a hard budget constraint to enforce financial discipline. We shall discuss first bank and then enterprise restructuring.

The inherited socialist banking systems could not provide the financial services required by market economies. The systems needed radical changes in their basic structure, including a new approach to central banking, changes in interest rate policy, new banking laws, regulations and supervision, more sophisticated payment systems, new approaches by banks to risk management and pricing, better systems for loan collection and enforcing financial contracts, opening of the financial system to competition, etc. These changes were needed to provide regular banking services, but in addition, governments asked banks to play a leading role in enterprise restructuring, that is, to identify and liquidate nonviable enterprises, restructure viable enterprises through debt relief and new lending, and provide guidance and direction to enterprise managers.

In the early days of the debate over financial reform, some advisers suggested that it was not advisable to restructure state banks. Their portfolio, their banking skills and their corporate culture were considered too weak. Rather it was argued that resources should be invested in new banks, while the old were allowed to wither away. For the most part this advice has been rejected. The countries of CEE chose to restructure and recapitalize most of the state banks formed out of the monobanks5/ and make these the core of the new banking system. The general approach followed

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4/ Beyond this generalization, it is possible to distinguish several types of restructuring programs. The Polish program assigned a major role for banks in restructuring enterprises. Slovenia is taking a similar approach. The Hungarian program, in its early stages, relied heavily on strict bankruptcy rules to force enterprise restructuring but is moving to bank led restructuring. The countries that have undertaken mass voucher privatization, Czechoslovakia, Russia, and Lithuania have a different approach. In Czechoslovakia the banks and enterprises were given some relief before being privatized. The banks have not gotten direct government relief in Russia and Lithuania. In Romania and Albania the government will play a larger role in restructuring enterprises.

5/ The split of monobanks into Central and state banks came in Hungary in 1987, in Poland in 1989, and in Czechoslovakia in 1990.

was to hire international accounting firms to audit banks, review portfolios, and estimate expected loans losses and capital requirements. The banks were recapitalized on the basis of ex ante expectations of loan losses. Banks whose collection performance exceeded expectations are allowed to keep the profits or bear losses if collections fall short of expectations. At the same time, banks undertook intensive training of staff and managers (e.g. twinning with western banks in Poland).

Russia, while not completely abandoning the state banks, has put far more reliance on new banks. In Russia the government licensed 2,000 new banks, some of which were spin-offs of the old state banks. Others started anew, usually as the subsidiaries of state enterprises. Loose licensing and widespread 'pocket' banking in Russia is likely to have significant costs to the economy. However, there are positive signs emerging from this seedbed approach to developing a new banking system. The smaller enterprise banks are losing importance as firms shift their business to the better financial institutions. Today the 20 largest non-state commercial banks account for more than one third of total bank assets. These growing, large commercial banks have recognized banking as a profitable business in its own right and are attempting to operate according to market principles.6/ These banks are not burdened with enterprise restructuring and can focus on commercial lending. The strategy adopted does, however, leave open the question of how to deal with the remaining state banks (still equal to one-third of the system) and what to do with private banks that fail. The Russian banking system has already had problems with fraud and mismanagement. Thus far about 40 banks have failed. Further bank failures could produce calls for government intervention.7/

There has been a tendency in the CEE programs to forget the early debate and to accept government-led restructuring as a necessity. Careful attention should be given to the alternative non-restructuring strategy being followed in Russia, at least on the margin. Not all state banks should be restructured; some are so weak they should be closed. Knowing they too can fail will improve the market discipline of banks that do not accept commercial practices.

Establishing arms-length economic relations among the budget, the banks, and the enterprises in the aftermath of planning is a central challenge for the transformation process. There is danger that

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6/ This observation must be treated with care. So far, the impact of the macroeconomic deterioration on the banks in the FSU has been muted because continuing high inflation is wiping out past lending mistakes and the budget constraint on enterprises remains soft with continuing negative real interest rates and arrears running through the system. The accounting system for banks is far from transparent and banking supervision is still too weak to verify the financial positions of the banks.

7/ For a more optimistic evaluation of developments in the Russian banking system, see G. Pohl, S. Claessens, "Banks, Capital Markets and Corporate Governance: Lessons from Russia for Eastern Europe." World Bank, May 1994.

bank recapitalization by government will be seen as a precedent for future bail-outs.8/ Multiple recapitalization of banks is likely to cause moral hazard as banks come to expect governments to periodically take over their bad loans leading banks to be less careful about lending decisions and loan collection.9/

While not a panacea, privatization is seen as one way to encourage commercial behavior by banks. There are two contrasting approaches to privatization of banks: (i) privatize the banks 'as is', i.e. without audits or restructuring; or (ii) restructure and recapitalize state banks before privatization. In Poland, two of the nine banks managed to solve their bad debt problems without government assistance and were privatized; the other banks will be privatized when the restructuring program is completed. Immediate privatization of the banks in Poland without prior restructuring was not considered acceptable: unreconstructed but privatized banks would likely need government assistance to cover debts. Such intervention would undermine the idea of privatization.

Rapid privatization without recapitalization was done in Latvia, Estonia and Russia. In other republics of the former Soviet Union state banks are being partially privatized and partially recapitalized through selling bank shares, e.g. Moldova and Armenia. Some of the banks privatized without restructuring and recapitalization are very weak and run the risk that state assistance will be necessary in the future. That is likely to be the case in Slovakia. If banks are sold to sophisticated investors - usually foreign banks - the buyers can be expected to review the portfolio and negotiate a price based on expected loan losses. But that is not true with voucher privatization. In this case banks should be fully recapitalized before privatization to prevent the need for further government intervention, which is tantamount to renationalization.

To date too little attention has been given to the questions of monopoly, scale efficiency, and the role of specialized banks. Some countries have either geographically specialized banks (e.g. Poland) or too few banks to be competitive (e.g. Slovakia) or too many small, weak banks (Russia). All

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8/ So far, Estonia is the only country where a large commercial bank has been liquidated without depositors being satisfied by the state. Several small banks failed in Poland - one was absorbed by a larger private bank and the others were liquidated. The failed banks had almost no household deposits and the losses were of depositors of the enterprises that had loans from the banks.

9/ The restructuring programs have addressed this "moral hazard" problem in different ways. In Poland, the recapitalization of banks was presented by the government as a one-time event covering only loans granted under the central planning regime. In Estonia recapitalization covered only the losses directly linked to the collapse of the Soviet Union; troubled banks which did not have assets in Russian banks were allowed to go bankrupt. In Hungary, on the other hand, the government has already injected capital into the banks several times. To moderate some of the negative consequences of moral hazard, Hungarian banks are being asked to agree to detailed restructuring plans and performance targets to qualify for the infusion of additional capital.

countries have specialized banks (particularly the savings banks and foreign trade banks) whose role needs reexamination. There are today obstacles that prevent market forces from guiding the evolution of structure. The most obvious is that only the savings banks have implicit deposit insurance, giving them a monopoly on household deposits.10/ In Slovakia over 75 percent of lending is in the hands of three banks and 90 percent of household deposits are in one bank. In many FSU Republics enterprises are still constrained to deal with one bank, making competition impossible. These banks use their control of the enterprises' payment accounts to enforce loan repayment.11/ The structural issues, being considered less urgent, have been left to a later time. Yet once the banks have been restructured and recapitalized and privatized, governments will have lost their ability to intervene, which suggests those issues should be dealt with at the time of recapitalization.

Although there has been a flurry of activity to set up the legal framework and a regulatory system, accounting, legal structures and bank regulation remain weak. Implementation and enforcement of bankruptcy proceedings are still spotty and the new regulatory institutions lack experience and enforcement powers. Moreover, while human capital is high, financial skills are spread thin in CEE/FSU. Both a weak regulatory/legal/informational framework and lack of financial skills will limit the ability of the banks to perform their assigned role in restructuring enterprises.

It is too early to generalize with much confidence about commercial bank performance in CEE/FSU. There are signs that, even in highly unstable and uncertain economic environments, good bank managements have been able to improve their own financial performance. This has been more true when inflation wiped out the value of the inherited bad debt making the quality of new lending of paramount importance to the financial health of the banks. Better banks stopped lending to loss making enterprises and enforced loan collection or liquidation. Given very wide spreads, banks that have avoided bad loans have been profitable and have been able to make provisions against their remaining portfolio problems.12/

10/ This is not true in Latvia where a private bank now has attracted about 1/3 of household deposits. This has turned out to be a very unstable situation. The private bank is insolvent but is now considered "too big to fail."

11/ Until there are stronger enforcement mechanisms for financial contracts, it will be difficult to lift the restrictions on sole banking relations. Moldova recently experimented with allowing enterprises to keep foreign exchange deposits in other banks. Within a matter of months it became apparent that enterprises had foreign exchange deposits in one bank and large arrears on loan payments to their primary banks without sufficiently strong legal infrastructure to enforce loan repayment.

12/ P. Dittus, "Corporate Governance in Central Europe: the Role of Banks". Bank for International Settlements. Draft. 1993. There has not been a similar effort to review bank performance in FSU, and the data would be highly unreliable because accounting reforms are still in an early stage and most banks do not correctly report expected loan losses.

Financial Restructuring of Enterprise

To understand the enterprise restructuring problem, it is useful to categorize enterprises according to profitability. The first class of enterprise is profitable; the second would be profitable if granted some form of debt relief. The third class of enterprise would not be profitable even with debt relief. This last class can be further subdivided into firms that are value-subtracting with revenues not adequate to cover the cost of purchased inputs and another class of somewhat better firms that can cover the costs of non-labor inputs plus some, though not all, wages. The third class of firms require more drastic restructuring, down-sizing, or liquidation.

In the countries where bank and enterprises restructuring is linked, the banks in their role as creditors, are expected to divide firms into the classes mentioned and to take action accordingly. Profitable firms required no relief. For firms considered viable but over-indebted, banks could either write down the outstanding debt or swap it for equity. For the firms considered non-viable even with debt relief, the banks are to use their power as creditors to force liquidation. Several countries have set up a special conciliation, that is a simplified bankruptcy, process giving banks special work-out powers usually free from the intervention of other creditors.

In CEE/FSU many of the largest loss makers fall in the category of value subtracters. Liquidating these firms, rather than continuing to subsidize their operations, would clearly benefit the economy and free up assets for use by the emerging private sector. Yet these large loss makers are sometimes either the biggest firms or major regional employers where liquidation poses complex social and political problems.13/ In some cases the firms which bring losses but are able to cover costs of non-labor inputs (enterprises with positive value added) are considered to be candidates for temporary wage subsidies; such a selective support targeted towards firms which have some prospects of economic viability and which operate in areas of acute distress could be treated as less expensive than cash transfers to those laid off. In most countries special government agencies have been set up to handle the restructuring decisions about those enterprises that are considered too large or too "strategic" to be managed by the banks.

Triage, coupled with financial workouts, is only the first step. Following that, banks are expected to finance the investments needed to restructure the viable enterprises and to play a role in corporate governance, that is, to provide oversight of decisions taken by enterprise managers.

13/ In many countries, including developed ones, the value-subtracting group contains also utilities. Because of very specific problems of this group the discussion of possible solutions is beyond the scope of this paper.

Banks as Enterprise Restructurers

It is still too early to evaluate outcomes, but there are several reasons for believing that the banks will not be able to carry out fully the role assigned in enterprise restructuring. Information on enterprise viability is still not very reliable in some countries, both because accounting is poor and because implementation of reforms has varied so widely. Though considerable progress has been made in most CEE countries in price liberalization, relative prices are more distorted in FSU where economies are still unstable and there has been less price and trade liberalization.14/

Information on firm viability is further clouded by implicit and explicit subsidies. In the first year of reform, it was argued that relative prices and other distortions made it difficult to decide which enterprises should be liquidated and which might eventually become viable. Neither the balance sheet, that is the level of debt, nor the income statement, that is the level of profits, were considered reliable guides to long run viability. Hence governments in the first year of reform did little to impose a hard budget constraint; rather they continued to provide enterprises with subsidies.15/ The budget constraint is much harder today, forced more by macro conditions than government choice. However, there are still distortions that cloud the information on enterprise viability. Widespread enterprise arrears, management fraud that skims off enterprise income, and poorly designed government interventions16/ reduce the value of enterprise profitability as an indicator of viability.

Though better positioned than others in terms of information and incentives to make appropriate decisions about the financial futures of enterprises, banks have only limited skills and experience in the workout process. Moreover, few banks in Central and Eastern Europe have yet been privatized and the instructions to public banks have been ambiguous on whether governments wished public banks to continue to support non-viable enterprises. In some countries banks are clearly not in a strong enough political position to enforce a hard budget constraint on enterprises, to work out a full

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14/ The results of several years of adjustment in CEE are visible. Inflation is coming down in the strong reformers, government budget deficits were lower in 1993 than in 1992, and currencies are internally and externally exchangeable. In the most advanced reformers, such as the Baltic states, the Czech Republic, Poland and Slovenia, the decline in output seems to have stopped, and real wages and unemployment stabilized, at least for now.

15/ Fan and Schaffer found that explicit subsidies amounted to about 25% of GDP in Russia in 1992, with only about one-third of these subsidies appearing in the government budget. Q. Fan, M.E. Schaffer, "Government Financial Transfers and Enterprise Adjustment in Russia, with Comparisons to Central and Eastern Europe." Mimeo. World Bank. 1994, p.54.

16/ Some form of social safety net for the unemployed is clearly needed. Unfortunately, that support has sometimes been of a kind to distort the information on sector and enterprise viability.

restructuring program, or to throw into liquidation those enterprises that cannot pay their debts. The situation is improving as more banks are privatized and governments introduce incentives for state banks to avoid lending to loss-making enterprises and to act more forcibly on enterprise restructuring.

There is a question of inconsistency between the commercial incentives for the banks and the role assigned by the government in restructuring. At one extreme, banks may want to liquidate more firms than governments are willing to allow.17/ On the other hand, banks have reduced their credit exposure to the weakest firms and may no longer have incentives to undertake time-consuming and costly bankruptcy proceedings. The mandate to restructure enterprises has diverted banks from their major line of business, that is mobilizing and allocating short term credit. Introducing legislation that allows for universal banking is one thing; expecting the banks of CEE/FSU to actually manage the restructuring of many enterprises is another.18/

Banks' Role in Financing Enterprise Restructuring

For the most part banks are not financing enterprise restructuring. On a voluntary basis they are providing short term commercial credits to profitable firms with adequate collateral. For banks this is and should be the major focus of their lending. Restructuring weak enterprises is a diversion. Most banks consider long-term loans to financing physical restructuring to be just too risky. Even profitable enterprises cannot get term credit, limiting the scope for expansion or rehabilitation of enterprises. There is a positive aspect to this conservative strategy. Bank lending may correctly reflect the best use of scarce resources. Given the general excess industrial capacity and the extreme shortage of resources in the transforming economies, financing working capital particularly for the new, private firms, probably has a higher expected return than most investment finance.

17/ In CEE many firms are being cut off from bank credit but bankruptcy has not been widely used yet. For example in Poland over 5000 firms had been declared uncreditworthy by 1993, but there had been relatively few bankruptcies or liquidations. Bankruptcies in Hungary are increasing, but these are usually initiated by the firm rather than the banks. In FSU the bankruptcy process has rarely been used. Russia had only eight bankruptcies in 1993. Moldova had none.

18/ In countries like Poland, where banks are growing increasingly independent of government, they have become quite aggressive in debt collection and enterprise liquidation, but their role in other aspects of enterprise restructuring remains limited. The survey of Polish enterprises by Pinto and van Wijnbergen (1994) led the authors to conclude that "banks played a powerful role in disciplining enterprises". It is important to note, however, that the banks started to use their power in executing financial discipline on enterprises only after their own governance changed as a consequence of banking reform at the end of 1991. In this reform the state banks were commercialized (supervisory boards were established) and brought under control of Ministry of Finance. There were two important implications of these changes: (i) for the first time the banks were audited by international auditing firms and the problem of bad debts was disclosed, (ii) in October 1991 the Ministry of Finance forbade lending to the firms in trouble. The conclusion from this is that the adjustment of banks was forced by rigorous execution of administrative decision. (B. Pinto, S. van Wijnbergen, "Ownership and Corporate Control in Poland: Why State Firms Defied the Odds." Mimeo. The World Bank, April 1994.)

There is a tendency to shortcut the development of fundamentals and to establish new lending programs and new financial institutions to address real and perceived market imperfections. In most of the countries proposals are being put forward to establish development banks to provide the term financing unavailable from commercial banks. Such proposals should be carefully scrutinized. The new institutions will suffer from many of the same problems as the banks, i.e. they often are public sector institutions, with rather unclear mandates, facing the same environmental issues as banks, and suffering from the same lack of skilled staff. The newly formed institutions have no special information or skills that will enable them to judge risk and returns better than the existing commercial banks. Though in some cases new programs or institutions may be able to overcome market imperfections, there is reason to believe that a proliferation of special programs and institutions will add to rather than overcome these imperfections. There is a real danger that government run development banks, in the present environment, could become a window of soft finance to money losing enterprises.

In fact the most serious problem in credit allocation in CEE/FSU is not a shortage of credit for investment finance but continued lending by public banks to non-viable enterprises usually at government behest. Such subsidies channel resources away from their most productive uses. However, a cost of transformation is both the error of continuing to lend to nonviable firms and failure to finance potentially viable firms.

Banks' Role in Corporate Governance

The expectation that banks would play a direct role in corporate governance seems to be happening only to a limited degree. Banks are disciplining firms through their power to withdraw short term credit lines and/or initiate the conciliation/bankruptcy process. Banks are playing a larger governance role for those few firms in which they have acquired an equity interest through a debt for equity swap. In addition, Czech banks exercise governance through the investment funds they run.

There are still gaping holes in corporate governance of the enterprise sector. The most profitable firms are finding strategic investors in the form of foreign corporations and domestic investment funds to take over governance. Most governments are setting up special property agencies to exercise their ownership responsibilities for those enterprises remaining in public hands. These state agencies are overstretched and control has been loose. Establishing corporate governance for the loss-makers is proving difficult. Strategic investors are not interested. The lack of effective corporate governance for the large loss-makers remains a serious problem.

It is difficult to reach strong conclusions on the basis of weak information. But the available evidence does seem to indicate that banks are performing to only a limited degree the role of enterprise restructuring. There are pressures on banks not to force a large number of enterprises into bankruptcy. Regardless of their view of firms' long run viability, banks are pursuing liquidation only when they see a clear financial gain. Though banks may well refuse them new credits no action will be taken against many firms with non-performing loans. Not execution, but slow starvation is likely to be the fate of most non-viable enterprises. With regard to the other aspects of the role assigned to, banks, the financing of new investment and providing corporate governance seem to be the exception, not the rule.

Stating that banks are not fulfilling the role of enterprise restructurers is not to argue that the role be assigned to a government agency. In so far as possible, except for the largest firms, a decentralized approach appears preferable. Rather the real impetus to enterprise restructuring has been, and is likely to remain, market forces, not government programs.

Figure 1

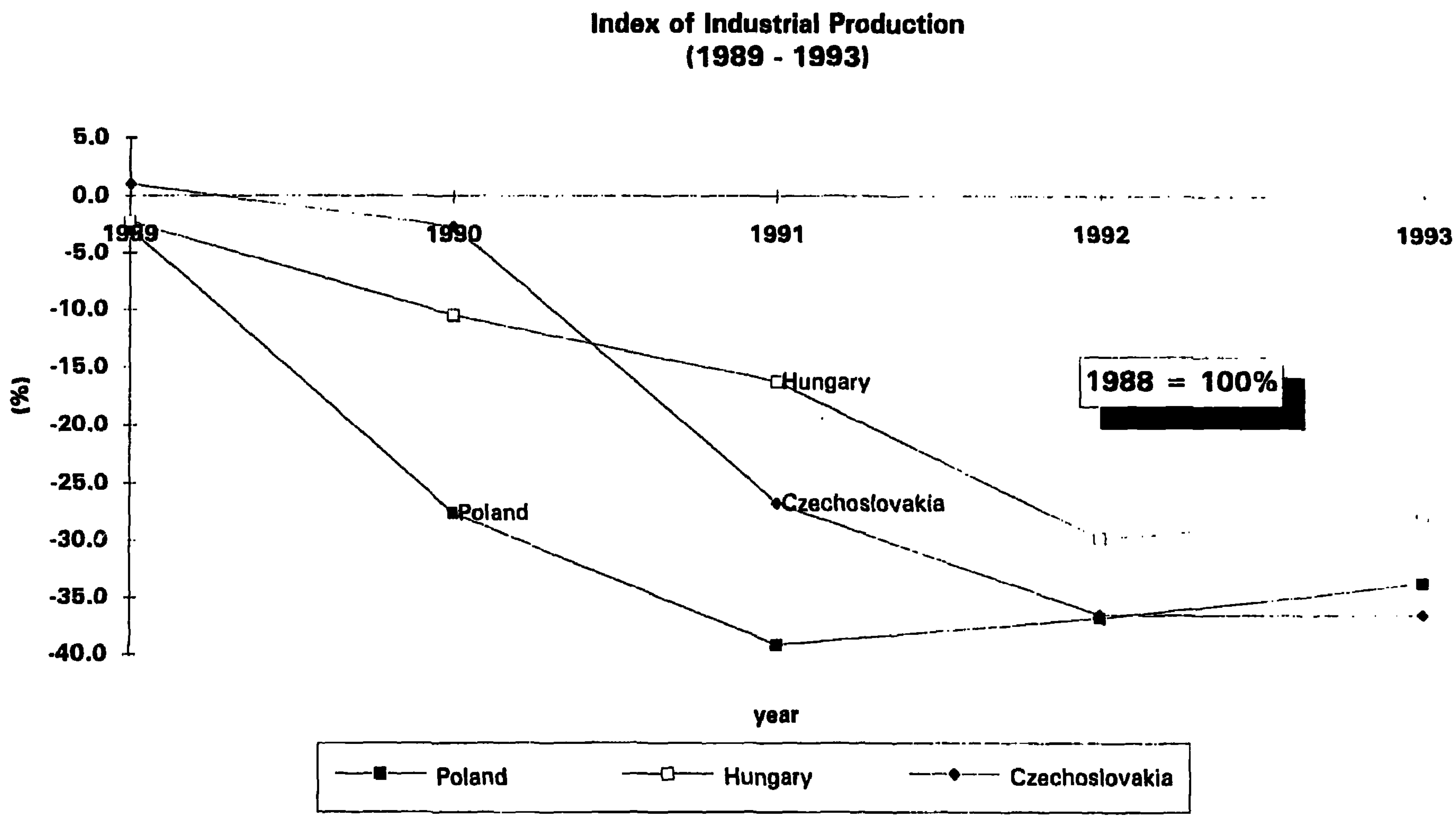
Index of Industrial Production
(1989 - 1993)
5.0
0.0
-5.0
-10.0
-15.0
-20.0
-25.0
-30.0
-35.0
-40.0
(%)
1989
1990
1991
1992
1993
Hungary
Czechoslovakia
Poland
1988 = 100%
year
Poland
Hungary
Czechoslovakia

Figure 2

Inflation and the Real Value of Debt (1989 - 1993)

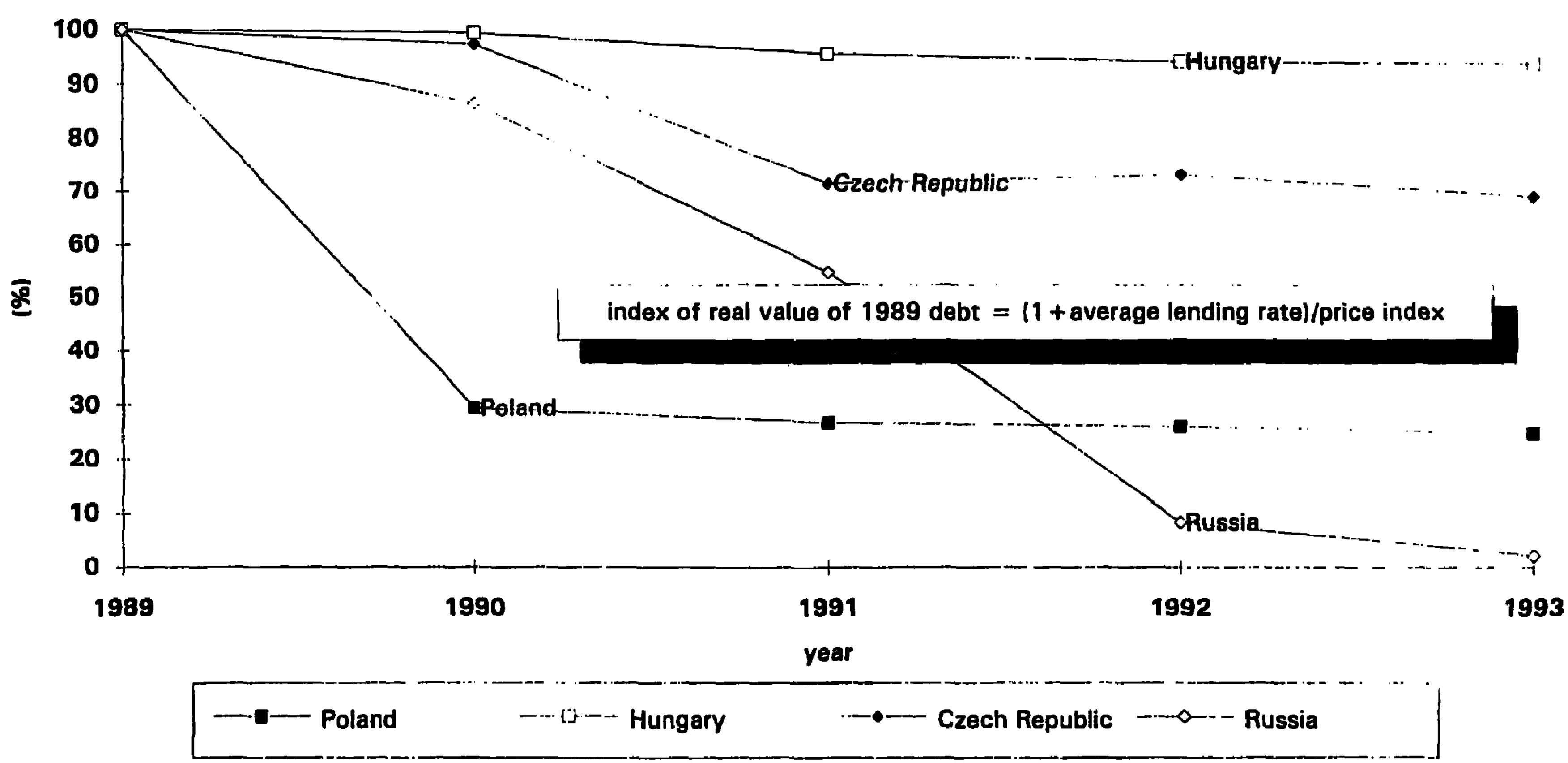

Table 1. Macroeconomic Indicators by Country

	Real GDP			Inflation			Unemp-loyment
	annual percentage change			*anuual average change of consumer prices (%)*			*(%)*
(%)	1991	1992	1993	1991	1992	1993	end 1993
Albania	-27.7	-9.7	11.0	35.5	225.9	85.0	
Bulgaria	-11.7	-5.6	-3.5	333.5	82.0	72.8	17.0
Former Chechoslovakia	-15.9	-8.5		59.0	11.0		
Czech Republic			0.5			20.8	4.0
Slovak Republic			-3.6				15.0
Hungary	-11.9	-4.5	-1.5	34.2	22.9	22.5	12.2
Poland	-7.6	1.5	4.8	70.3	43.0	35.3	15.7
Romania	-15.1	-13.5	0.0	161.1	210.3	256.0	9.5
Slovenia			-6.0			22.9	
Armenia	-11.8	-52.0	-28.0	100.0	790.0	2500.0	
Azerbaijan	-0.7	-26.8	-14.4	105.6	611.3	797.5	
Belarus	-1.9	-11.0	-11.7	83.5	969.0	1188.0	0.9
Estonia	-11.3	-19.3	-3.5	210.6	1069.0	89	2.8
Georgia	-20.6	-45.6	-30.0	78.5	887.5	1480	
Kazakhstan	-13.0	-14.0	-10.0	147.0	2568.0	2146.9	
Kyrgyz Republic	-5.0	-19.1	-16.4	85.0	854.6	1208.7	
Latvia	-8.3	-33.8	-10.1	124.4	951.2	109	6.1
Lithuania	-13.1	-37.7	-16.2	224.7	1020.3	410.4	1.7
Moldova	-18.0	-21.3	-15.0	162.0	1276.0	1340	
Russian Federation	-12.9	-18.5	-11.5	92.7	1353.0	895	1.0
Tajikistan	-8.7	-30.0	-30.0	111.6	1156.7	1869.9	
Turkmenistan	-4.7	-5.3	8.5	102.5	492.9	1860	
Ukraine	-11.9	-13.7	-18.0	91.2	1445.3	4927.9	0.5
Uzbekistan	-0.9	-9.5	0.0	105.0	528.0	761	

Source: World Economic Outlook, October 1993 and May 1994, IMF.

Annex

Table 2. Macroeconomic Indicators by Region

(%)	1988	1989	1990	1991	1992	1993
Real GDP			*(annual percentage change)*			
Central Europe	1.5	0.2	-7.1	-12.6	-9.1	-1.6
Former U.S.S.R.	5.3	3.0	-2.3	-11.8	-17.8	-12.4
Employment			*(annual percentage change)*			
Central Europe			-1.6	-5.8		
Former U.S.S.R.			-0.6	-2.0		
Inflation			*(consumer prices, annual percentage change)*			
Central Europe	42.3	135.5	157.7	119.3	162.2	141.7
Former U.S.S.R.	0.3	2.3	5.4	98.1	1284.6	1224.2
Central Government Fiscal Balance			*(in percent of GDP)*			
Countries in Transition	-2.4	-2.6	-4.8	-10.3	-10.5	-8.0
Growth of Broad Money			*(annual percentage change)*			
Countries in Transition	22.2	32.4	22.1	125.9	602.1	352.1
Current Account Balance			*(in billions of US dollars)*			
Central Europe	5.9	2.8	0.3	-6.1	-1.2	-6.3
Former U.S.S.R.	1.8	-6.0	-17.0	0.3	-4.0	-0.2
External Debt			*(in billions of US dollars)*			
Central Europe	98.2	98.3	108.4	108.6	107.4	109.4
Former U.S.S.R.	43.0	55.0	61.1	67.0	78.9	90.9
External Debt			*(in percent of exports of goods and services)*			
Central Europe	123.7	124.2	150.9	174.7	159.1	170.0
Former U.S.S.R.	32.5	41.1	47.3	65.8	114.4	117.6

Source: World Economic Outlook, May 1994, IMF.

Central Europe consists of:

Albania, Bulgaria, Croatia, Czech Republic, Former Czechoslovakia, Hungary Macedonia, Poland, Romania, Slovak Republic, Slovenia, Former Yugoslavia

Former U.S.S.R. consists of:

Armenia, Azerbaijan, Belarus, Estonia, Gerogia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan

Table 3. Industrial Output and Services as % of GDP

(%)	Industry 1989	Industry 1992	Services 1989	Services 1992	Increase (1989-1992) Industry	Increase (1989-1992) Services
			High-income economies			
France	29.2		67.3			
Germany	39.1		59.2			
Italy	33.9		62.6			
Spain	35.3		59.9			
Ireland	9.5		79.5			
			Transitional economies			
Poland	52.4	46.6	34.7	41.9	-5.8	7.2
Hungary	36.4	29.5	50.0	63.4	-6.9	13.4
Czechoslovakia	52.6		37.9			
Bulgaria	59.4	44.7	29.7	41.4	-14.7	11.7
Romania	59.2	46.4	26.9	33.7	-12.8	6.8
Slovenia					0.0	
Estonia	43.9	48.8	36.3	34.1	4.8	-2.2
Latvia	44.6	52.9	36.1	23.2	8.2	-13.0
Lithuania	44.9		27.9			
Russia	48.2					
Kazakhstan	34.2		37.2			
Uzbekistan	40.2	38.2			-2.0	
Armenia	54.6		34.0			
			Middle-income economies			
Greece	27.1		55.9			
Turkey	35.4	30.0	47.9	55.4	-5.4	7.5
Mexico	32.3	28.4	60.0	63.2	-3.9	3.2
			Low-income economies			
India	29.1	27.4	39.6	40.2	-1.7	0.6
Malawi	19.5	21.8	45.6	50.0	2.3	4.4
Nicaragua	21.2	19.3	46.7	50.3	-2.0	3.6

Source: World Tables, The World Bank, 1994.

** industry is defined as mining and quarrying, manufacturing, construction, electricity, gas and wate*

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